

Congressman Michael G. Fitzpatrick  
4/12/2005

Capital Markets, Insurance and Government Sponsored Enterprises Hearing: "Reforming Credit Rating Agencies: The SEC's Need for Statutory Authority"

Even though I am new to this Committee, it seems to me that the oversight of the credit rating industry is insufficient. It is troubling that the largest nationally recognized statistical rating organizations – S&P, Moody's, and Fitch – rated Enron at investment grade until four days before its bankruptcy filing in 2001, and all three rated WorldCom at investment grade until 42 days before its filing in 2002.

Rating agencies play an important role in our market. Far more debt is issued than stock, but there is an inherent conflict of interest. Rating agencies earn fees charged to the companies whose debt they rate. This divergent business model means that the paying customers for these agencies are the corporations they analyze, not the investors who look to the ratings for help in assessing a company's creditworthiness.

Let me provide a local example that I believe illustrates the problems with the industry and the manner in which it is regulated. In 1998, Egan-Jones Ratings of Philadelphia applied unsuccessfully to the S.E.C. It rates approximately 800 companies and had warned of problems at WorldCom, Enron and Global Crossing well before other agencies. Egan-Jones does not have a conflict of interest like the other nationally recognized statistical rating organizations. It does not accept payment from the companies it rates; the investors who use its services pay for the analysis.

A recent academic study compared ratings by Moody's with those of Egan-Jones. Reputable academics found that Egan-Jones's ratings changes were more timely than those of Moody's. The study also found much higher stock returns after rating changes by Egan-Jones than by those of Moody's. The study concluded that Egan-Jones is more responsive and closely associated with investors.

Timely, accurate credit ratings are critical for our robust marketplace. We must be certain that we are protecting the investor, in particular small investors. These investors will continue to be hurt until someone addresses the basic problems of the ratings industry.